No. 378

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

THE FIRST NATIONAL BANK,
Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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FIRST NATIONAL BANK, *Petitioner,* —*against*— COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable The Chief Justice and the Associate Justices of the United States:

The petitioner prays the issuance of a writ of certiorari to the United States Court of Appeals for the Second Circuit to review the judgments and decisions of that Court rendered on May 11, 1955 and June 7, 1955, affirming an order of the Tax Court of the United States on the opinion of the Tax Court promulgated on April 30, 1954 and denying a petition for rehearing.

Citations to Opinion and Decisions Below

The opinion of the Tax Court is reported in 22 T. C. 209, and appears at R. 72. It is printed in the appendix to petitioner's brief below. The decision of the Court of

Appeals for the Second Circuit is reported in 221 F. 2d 959.

Jurisdiction

The judgment of the Court below denying the petition for rehearing was entered on June 7, 1955. The jurisdiction of this Court is invoked under Sections 1254 and 2101 of the Judicial Code, effective September 1, 1948 (28 U. S. C.).

Questions Presented

1. Whether in computing a bad debt "recovery exclusion" under Section 22(b)(12) of the Internal Revenue Code of 1939, and the extent to which the deduction on account of the bad debt did not result in tax benefit, the true net loss for the year of the deduction should be considered or only the net loss as reported on the return for that year after the statute of limitations for filing refund claims and assessing deficiencies has run on such year?

2. In Section 22(b)(12)(D) do the words "did not result in a reduction of taxpayer's tax" indicate that Congress intended, in providing an income tax exclusion for a bad debt recovery to the extent that no tax benefit was derived from the deduction of the bad debt, to bar consideration of additional items of income, deduction and exclusion not reported on the return for the year in which the bad debt was deducted after the statute of limitations for filing refund claims and assessing deficiencies has run on such year?

3. Does the fact that the statute provides a recovery exclusion only with respect to bad debts for which a deduc-

tion was allowed for a prior taxable year indicate that Congress intended only allowed deductions and exclusions to be considered in determining the tax benefit derived by the bad debt deduction?

Statute Involved

The statute involved is Section 22(b)(12) of the Internal Revenue Code of 1939 and is set forth in the appendix hereto.

Statement

The facts are not in dispute. The petitioner in 1937 charged off an unpaid loan as a bad debt and claimed it as one of the income tax deductions on its 1937 return. The excess of all deductions and exclusions claimed in the 1937 return over income reported resulted in a net loss on the return of $6,023.35. Petitioner had more items of exclusion and deduction (not attributable to bad debts, prior taxes and delinquency amounts) which, although concededly allowable, were not excluded or deducted in the return. Taking these items into account, petitioner's net loss for 1937 was $19,254.74.

In 1949, when the statute of limitations for making refund claims or assessing deficiencies had run on 1937, a recovery on the bad debt was realized. Petitioner maintains that part of this recovery should be excluded from 1949 income under Section 22(b)(12) of the Internal Revenue Code of 1939 for although the recovery together with other previous recoveries of bad debts deducted in the 1937 return exceeded the net loss shown on the 1937 return, considering the true loss in 1937 the petitioner realized no tax benefit to this extent on account of the bad debt deduction with respect to this recovery.

The Tax Court held that the petitioner was not entitled to a recovery exclusion under Section 22(b)(12) because the statute defines "recovery exclusion" to be the amount of a deduction allowed on account of the bad debt "which did not result in a reduction of the taxpayer's tax". The Tax Court interpreted this to mean that the exclusion must be based on the 1937 return as filed and that no change in the net loss shown on the return can be considered for the purpose of determining the tax benefit and recovery exclusion after the statute of limitations for filing claims for refund or assessing deficiencies has run on 1937, the year in which the bad debt was deducted. The Court of Appeals affirmed the order of the Tax Court on the opinion of the Tax Court and denied a petition for rehearing.

Reasons for Granting the Writ

1. The decision below, although adverse to the taxpayer here, may seriously prejudice the Commissioner of Internal Revenue in future cases involving the precise issue.

Petitioner, like most taxpayers, wishes to pay no more tax than is due. However, petitioner is also concerned in protecting the interests of its Commissioner of Internal Revenue and in preventing any serious hindrance to the effective administration of the tax laws. Because of the relatively small amount of tax involved in the present case, this latter concern as well as the former has been a principal reason for the time, effort and expense of appealing the decisions of the courts below.

The instant case presents a question whose resolution will have immediate importance far beyond the particular facts and taxpayer involved. A very important principle is in issue upon which the rights and revenue of a great many

taxpayers throughout the country depend. It is whether taxpayers may show the true facts with regard to their tax liabilities and whether the Commissioner of Internal Revenue is barred from reaching those true facts in the absence of clear statutory authority to the contrary.

The Tax Court and the Court of Appeals held that for the purpose of computing the tax benefit from a bad debt deduction and the recovery exclusion under Section 22(b)(12) of the Internal Revenue Code of 1939, no consideration can be given to items of income, deduction or exclusion after the statute of limitations has run on the year in which the deduction was claimed.

Such a rule once established must work both ways, preventing the Commissioner from going behind the statute of limitations in adjusting a loss in an earlier year claimed as the basis for a recovery exclusion. For example, if in an earlier year a taxpayer in his return claims an improper deduction on account of a bad debt or fails to report proper items of income, and on audit of the return the Commissioner fails to correct such errors or fails to audit the return at all, the Commissioner when the statute of limitations has run is barred from correcting the earlier errors by assessing a deficiency and is also barred from disallowing a recovery exclusion in the year of recovery. Furthermore, even if the Commissioner in auditing the earlier return discovers an error before the statute of limitations has run, there is nothing he can do about correcting it on the return if after the correction the return would show a net loss for the Commissioner can assess a deficiency only if there is no net loss.

2. The decision below imposes an undue burden on taxpayers. The Internal Revenue Code requires a taxpayer to report the amount of tax due in any year. In years in

which the taxpayer has losses, he has no tax. In these loss years he is neither motivated nor obligated to list on his tax return every possible deduction or exclusion since any additional deduction or exclusion cannot reduce his tax less than nothing. The effect of the decision below is to force all taxpayers in the future to claim on every return all deductions and exclusions, whether needed or not to eliminate taxable income.

It is believed that Congress never intended such results and that under a proper interpretation of the statute taxpayers are to be permitted to present evidence of additional deductions in prior years in computing a recovery exclusion so that the true tax benefit derived in those years can be determined. The decision below is as novel as it is far-reaching and clearly calls for review by this Court.

3. The decision of the Court of Appeals conflicts with applicable decisions of this Court. The Tax Court decided the case and the Court of Appeals affirmed on the theory that where the statute of limitations has run on the year in which a bad debt was deducted and a recovery of the bad debt occurs in a later year, a recovery exclusion is permitted only upon the basis of the return as filed for the earlier year without regard to the true facts in the earlier year. The issue before the Court was whether the petitioner for the year 1949 was entitled to a recovery exclusion under Section 22(b)(12) of the Internal Revenue Code of 1939 resulting from a recovery of a debt previously charged off in 1937. The statute excludes from gross income recoveries of previously deducted bad debts to the extent that the prior deduction "did not result in a reduction of the taxpayer's tax". Under the statute, therefore, when the "prior deduction" occurred in a year in which the taxpayer sustained a loss, the taxpayer can show that it had no tax benefit if

there would have been a net loss for the year without the bad debt deduction.

Under an unbroken line of cases from *Lewis* v. *Reynolds,* 284 U. S. 281 (1932), to *Commissioner* v. *Van Bergh,* 209 F. 2d 23 (2d Cir. 1954), this Court and other courts have consistently held that when a taxpayer files a claim for refund, the Commissioner may examine the entire return for the year involved and assert offsetting adjustments, even though the statute of limitations has already run by the time the Commissioner makes his determination. Conversely, when the Commissioner asserts a deficiency against a taxpayer, the taxpayer may, even after the year is barred by the statute of limitations for claiming refunds, claim offsetting adjustments in that year. The principle involved in both these instances is that net refunds or deficiencies are based on the true tax for the year involved. The decision by this Court in *Bull, Executor* v. *United States,* 295 U. S. 247 (1935), is to the same effect. The Tax Court and the Court of Appeals have violated this principle in interpreting the statute so as to deny the petitioner the right to show the true facts for the year 1937, and the decision below conflicts with all the decisions of this Court and other courts establishing the principle.

4. The decision below interprets Section 22(b)(12) of the Internal Revenue Code of 1939 in a manner which is inconsistent with the administrative practice of the tax laws and with other sections of the Internal Revenue Code. The case, therefore, presents an important question of statutory interpretation. Cases will continue to rise under this section of the Internal Revenue Code of 1939 and under the corresponding section of the Internal Revenue Code of 1954 and under future revisions of the Code.

The Tax Court in its opinion attempted to ascertain the intent of Congress with respect to Section 22(b)(12) from the language of the statute, the legislative history, and from general principles with respect to the administration of the tax laws. The result reached, however, is nowhere expressed in or required by the statute, the legislative history, or the administrative practice. The only "evidence" of an intent of Congress to place such a restriction as found by the courts below on the recovery exclusion provided in Section 22(b)(12) is the fact that the recovery exclusion is limited to bad debts "allowed" in a prior taxable year, and that "recovery exclusion" is defined to be the amount which "did not" result in a reduction of the taxpayer's tax. These are certainly not clear enough indications to demand such a novel and far-reaching result or to justify reading the words "taxpayer's tax" in Section 22(b)(12)(D) of the statute as tax reported on an income tax return filed for the earlier year and "tacitly approved" by the Commissioner.

There is not a particle of justification in the statute for concluding that because no change could be made in the bad debt deduction for 1937 since the statute refers only to those bad debts for which a deduction was "allowed for a prior taxable year" that there can be no change in other deductions in computing the tax benefit that has been derived. Congress intended to make it clear in the statute that a recovery exclusion is permitted only with respect to a bad debt which has been claimed as a deduction in a prior year. Prior to the enactment of the statute the Commissioner had taken the position that a recovery of a bad debt which was allowable but not deducted in a prior year was taxable income in the year of the recovery. Congress in enacting Section 22(b)(12) clearly intended to tax the

recovery of a bad debt only to the extent that tax benefit was derived from a deduction of the bad debt. Since no tax benefit could possibly be derived from a bad debt which although allowable was not deducted and "allowed", no recovery exclusion was necessary except for "allowed" bad debts, and it would have made no sense to provide one for "allowable" bad debts. Since no benefit could be derived from an "allowable" as distinguished from an "allowed" bad debt, there would be no use for a taxpayer to attempt to obtain a recovery exclusion by changing the bad debt deduction as reported on the return. There is no reason, therefore, for the inference drawn by the courts below from the definition of "bad debt" in Section 22(b)(12)(A).

The Tax Court pointed out that Section 22(b)(12)(D) defines "recovery exclusion" as the amount of a bad debt deduction "which did not result in a reduction of the taxpayer's tax", and that in the legislative history of the provision the expression "did not in any prior year reduce his income tax liability" or its equivalent appears several times. The courts below reasoned that these words "did not" indicate that Congress meant to bar consideration of additional items of income, deduction or exclusion not reported in the tax return for the year in which the bad debt was deducted after the statute of limitations has run on such year. The Tax Court said that the petitioner is bound by the return which was filed for 1937 and which was "tacitly approved by the Commissioner" (the return was audited but no change made), and it may not now show that the amount which "did not result in a reduction" of its income tax for 1937 was in excess of the net loss shown on the 1937 return. The Tax Court reached this conclusion by reasoning that in order for the petitioner to be entitled to a recovery exclusion the statute would have to be read "would not have

resulted in a reduction of the taxpayer's tax". The Tax Court said that this result was required because the petitioner *might have* included its additional deductions in the return and that the return *might have* shown for 1937 a larger loss than it did. This is very strained reasoning. It is just as easy, and more natural, to read the phrase "did not result in a reduction of the taxpayer's tax" to mean that looking at the true facts for the year 1937 the taxpayer is entitled to a recovery exclusion only to the extent that the deduction for the bad debt in 1937 did not result in any tax benefit. The "taxpayer's tax" is certainly not any figure reported on an income tax return, even though the statute of limitations for filing refund claims or assessing deficiencies for that year has run. The "taxpayer's tax" for computing a recovery exclusion must mean the taxpayer's true tax. As a matter of English and of semantics "did not" when used in the phrase "did not result in a reduction of the taxpayer's tax" more properly means did not result in a reduction of taxpayer's true tax than it does did not result in a reduction of the taxpayer's tax as reported on the return filed by the taxpayer and "tacitly approved" by the Commissioner.

In numerous sections of the Internal Revenue Code of 1939, when Congress wanted to limit the adjustments for a prior year it specifically wrote such limitations into the statute. Sections 22(e)(6), 452, 734(d) and 3801 are examples where such provisions appear. It is apparent from these provisions that Congress on numerous occasions prior to the enactment of Section 22(b)(12) had considered limitations such as the Tax Court suggests and had written them into the statute when it intended to impose such limitations.

The Commissioner's regulations, Regulations 111, Section 29.22(b)(12)-1, indicate that a "computation" for the purpose of the "recovery exclusion" is necessary. Also the logical reference of the word "tax" in the regulations like in the statute is to the correct tax for the year of loss.

The Tax Court's reasoning that there should be a terminal date to establish the taxability of any given year is not applicable in these recovery exclusion cases since Congress specifically made an exception to the statute of limitations by enacting Section 22(b)(12). The recovery exclusion statute provides taxpayers relief from the statute of limitations by granting an income exclusion on the recovery of a bad debt even though the statute of limitations has run on claiming refunds with respect to the earlier year in which the bad debt was deducted.

As a matter of statutory construction, therefore, it would seem crystal clear that the petitioner is entitled to a recovery exclusion. Nor is there anything in the legislative history of the statute evidencing a different intention. Moreover, the rule established by the decision below will create a hardship for taxpayers and the Commissioner of Internal Revenue alike, which Congress certainly must never have intended.

Conclusion

The Court of Appeals decisions affirming the Tax Court and denying the petition for rehearing are in conflict with applicable decisions of this Court, attribute unwarranted restrictions to Section 22(b)(12) of the Internal Revenue Code of 1939 and to corresponding sections under successive revenue acts and raise a question of continuing public importance in the administration of Federal tax law. A

writ of certiorari to review the decisions with a view of reaching a fair and equitable rule applicable to taxpayer and Commissioner alike in these recovery exclusion cases should therefore be granted.

Respectfully submitted,

JOHN A. REED
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15 Broad Street
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New York, N. Y., September 2, 1955

APPENDIX

Section 22(b) of the Internal Revenue Code of 1939 provides as follows:

"(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

(12) Recovery of bad debts, prior taxes, and delinquency amounts.—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) Definition of bad debt.—The term 'bad debt' means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) Definition of prior tax.—The term 'prior tax' means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(C) Definition of delinquency amount.—The term 'delinquency amount' means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) Definition of recovery exclusion.—The term 'recovery exclusion', with respect to a bad debt, prior tax, or delinquency amount, means

the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph."

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

CALENDAR NO. 155—OCTOBER TERM, 1954

Argued April 22, 1955 Decided May 11, 1955

FIRST NATIONAL BANK,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before: FRANK, MEDINA and HINCKS, Circuit Judges.

Appeal from an order of the Tax Court of the United States, per Judge Murdock. AFFIRMED.

JOHN A. REED and FRANCIS E. RINEHART,
for Petitioner

H. BRIAN HOLLAND, ELLIS N. SLACK and
DUDLEY J. GODFREY, JR.,
for Respondent.

PER CURIAM:

The order of the Tax Court is affirmed on the opinion of Judge Murdock, reported in 22 T. C. 209.

Filed 6/7/55

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

FIRST NATIONAL BANK,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before: FRANK, MEDINA and HINCKS, Circuit Judges.

On Petition for Rehearing.

JOHN A. REED and FRANCIS E. RINEHART,
Attorneys for Petitioner

PER CURIAM:

Petition for rehearing denied.

/s/ JEROME N. FRANK
Jerome N. Frank, U. S. C. J.

/s/ HAROLD R. MEDINA
Harold R. Medina, U. S. C. J.

/s/ CARROLL C. HINCKS
Carroll C. Hincks, U. S. C. J.